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Intergovernmental Working Group of
Experts on International Standards
of Accounting and Reporting
Fourteenth session
Geneva, 1 July 1996

Item 2 of the provisional agenda

PROVISIONAL AGENDA AND ANNOTATIONS FOR THE FOURTEENTH SESSION OF THE WORKING GROUP

I. PROVISIONAL AGENDA

1. Election of officers

2. Adoption of the agenda and organization of work

3. Accounting and reporting by commercial banks, including disclosures on bank structures and related party disclosures, and on the appointment and rotation of auditors

4. Accounting for government concessions

5. Other business
   (a) Oral report on national surveys on reasons for non-compliance with international standards of accounting and reporting and recommendations, based on the surveys, to remedy deficiencies;
   (b) Oral report on transfer pricing methods and current practices;
   (c) Oral report on accounting developments at the global level;
   (d) Oral report on the proposed subgroups on global qualification standards for accountants (including accounting technicians) and on a professional accreditation system based on global qualification standards;
   (e) Oral report on follow-up activities relating to topics considered at the Group's thirteenth session

6. Provisional agenda for the fifteenth session of the Group

7. Adoption of the report of the Working Group on its fourteenth session.

II. ANNOTATIONS TO THE PROVISIONAL AGENDA

Item 1. **Election of officers**

It is suggested that the Intergovernmental Working Group of Experts elect a Chairman, 5 Vice-Chairmen and a Rapporteur, in accordance with rules 18 and 19 of the rules of procedure of the main Committees of the Board. [1]

Item 2. **Adoption of the agenda and organization of work**

The provisional agenda for the fourteenth session was approved at the closing plenary meeting of the thirteenth session of the Intergovernmental Group of Experts, on 17 March 1995.

Concerning the organization of the work of the session, the Group has five working days available. It is therefore suggested that the first plenary meeting, on 1 July, be devoted to procedural matters (items 1 and 2), general statements and consideration of item 3. Subsequent meetings (i.e. from the afternoon of Monday 1 July to the close of the afternoon meeting on Wednesday 3 July) will be devoted to the accounting and reporting topics (items 3 to 5), including details of follow-up activities since the previous session including the on-going liaison between the secretariat and the World Trade Organization's Working Party on Professional Services and the proposed system for accreditation of accountancy qualifications, the ad hoc meeting (which took place in Geneva during the period 6 - 8 December 1995) on environmental accounting. On Thursday 4 July a special forum on the bankers' views on disclosure and accounting-related matters will take place. The last plenary meeting, on Friday 5 July, would be devoted to items 6 and 7.

The secretariat will prepare a tentative sequence of issues to be dealt with by the meeting which will be available on the first day.

Item 3. **Accounting and reporting by commercial banks, including disclosures on bank structures and related party disclosures, and on the appointment and rotation of auditors**

The management and accountants of commercial banks have come under criticism as a consequence of the increasing number of incidents of failure and/or severe financial difficulties. The report on this item investigates the various aspects of disclosure by commercial banks and considers the special nature of bank audits. Deregulation of the banking industry has resulted in a shift of commercial activity towards increasingly speculative and complex transactions which can have a significant impact upon the financial results of banks. Current accounting and reporting standards and guidelines are considered within the report.

Documentation

TD/B/ITNC/AC.1/9 Commercial banking accounting and disclosures

Item 4. **Accounting for government concessions**

The report describes the various types of government concessions and other forms of governmental assistance, privileges and benefits and how they should be accounted for and disclosed within financial statements. Currently, there are no international accounting standards specifically on this topic. However, the International Accounting Standards Committee has issued International Accounting Standard IAS 20 "Accounting for Government Grants and Disclosure of Government Assistance". The Group has already discussed accounting for government grants during its twelfth session and reconfirmed its earlier guidance. It decided to take up the issue of "concessions" as distinct from "grants" at a future session.

Documentation

TD/B/ITNC/AC.1/8 Accounting and reporting for government concessions

Item 5. **Other business**

Listed under "Other business" are a number of diverse topics, some of a substantive nature and others of a follow-up nature on the ongoing activities of the Working Group. Each of these topics is briefly described below.

(a) **Oral report on national surveys on reasons for non-compliance with international standards of accounting and reporting and recommendations, based on the surveys, to remedy deficiencies**

Documentation

TD/B/ITNC/AC.1(XIV)/CRP.1 Compliance with international accounting standards

This paper is the draft Chapter VI of the forthcoming publication *International Accounting and Reporting Issues: 1995 Review*. The paper is based upon a survey designed to identify reasons why national accounting standards do not comply with international ones. A number of causes are noted such as differences in legal and taxation systems and the different uses for financial statements.

(b) **Oral report on transfer pricing methods and current practices**

Documentation

TD/B/ITNC/AC.1(XIV)/CRP.2 Transfer pricing regulations and transnational corporation practices: guidance for developing countries

This paper is the draft Chapter IV of the forthcoming publication *International Accounting and Reporting Issues: 1995 Review*. The paper describes transfer pricing, particularly methods for detecting the extent of transfer pricing and the practices of various countries in dealing with it. Recommendations are made for improving these methods and practices particularly form the point of view of the accounting information needed by home and host governments.

(c) **Oral report on accounting developments at the global level**

Documentation

TD/B/ITNC/AC.1(XIV)/CRP.3 Accountancy developments at the global level

This paper is the draft Chapter I of the forthcoming publication *International Accounting and Reporting Issues: 1995 Review*. This periodic review includes the most significant issues on standard-setters' agendas and discusses the approaches being taken to deal with them.

(d) **Oral report on the proposed subgroups on global qualification standards for accountants (including accounting technicians) an on a professional accreditation system based on global qualification standards**

The secretariat will report to the Group on activities of the Working Party on Professional Services of the World Trade Organization and its relationship with UNCTAD. Furthermore, the secretariat has considered the feasibility of developing the global qualification and reports that such a task remains useful and the work has commenced.

(e) **Oral report on follow-up activities relating to topics considered at the Group's thirteenth session**

Documentation

TD/B/ITNC/AC.1(XIV)/CRP.4 Current developments in environmental accounting

This paper is the draft Chapter V of the forthcoming publication *International Accounting and Reporting Issues: 1995 Review*. The chapter describes various aspects of environmental accounting including the guidelines and standards which have been prepared by various accountancy bodies around the world. An ad hoc session of the Group was held in Geneva from 6 to 8 December 1995 to review this paper. The report of the session is included within this paper as the conclusion.

Lastly, at the request of the Working Group, the secretariat has organized a forum on the bankers' view on disclosure and accounting-related matters by commercial banks. Five experts from the banking community will serve as panellists for this one-day session.

Item 6. **Provisional agenda for the fifteenth session of the Working Group**

The provisional agenda for the fifteenth session must be approved during the fourteenth session. The Working Group may wish to consider the recommendations made for further work by the ad hoc session and the contents of document TD/B/ITNC/AC.1(XIV)/CRP.4 previously described.

Item 7. **Adoption of the report of the Working Group on its fourteenth session**

The Working Group will report to the Commission on Investment, Technology and Related Financial Issues at its first session.

Notes

1. UNCTAD, Rules of Procedure of the main Committees of the Trade and Development Board, (TD/B/740), United Nations, New York, 1979.

2. TD/B/ITNC/AC.1/6

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Intergovernmental Working Group of
Experts on International Standards
of Accounting and Reporting
Fourteenth session
Geneva, 1 July 1996
Item 3 of the provisional agenda

ACCOUNTING AND REPORTING FOR GOVERNMENT CONCESSIONS

Report by the UNCTAD secretariat */

Summary

At its twelfth session the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting considered the report "Accounting for Government Grants and Concessions (E/C.10/AC.3/1994/6)" and a conclusion was reached that accounting for concessions deserved further and more detailed attention to certain issues. It is for this purpose that this report has been prepared. This report covers accounting for various types of government concessions: services contracts; build/operate/transfer transactions (BOT); concessions for the use or operation of public assets; management contracts and various other privileges or advantages given by governments to enterprises. The principles contained in this report could be useful to international and national standard setters in the formulation of accounting standards because currently there are no standards which specifically address the majority of these transactions.

*/ This report was prepared with the assistance of Professor Lazaro Placido Lisboa, University of Sao Paulo, Brazil.

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INTRODUCTION

1. This report is intended to give guidance on accounting and reporting issues relating to concessions received from governments because at the present time there is no comprehensive international standard in this area. In some developing countries and countries in transition, concessions are very significant and widely used to attract foreign direct investment and technology. Concessions may be used even more intensively in the future because the arrangements allow governments to shift the provision of public services to the private sector allowing the government to concentrate on activities which have greater priority and/or which are non-transferable. Hence, there is a growing demand for addressing this topic.

2. Concessions can be, and frequently are, granted by national, regional (state) or municipal governments (herein called the grantor) to an enterprise (referred to as the grantee or concessionaire), which may be publically-held or privately-owned or could be quasi-governmental, to operate a public service, carry out public works or make use of public assets. The concessions are usually for a fixed and possibly long-term period during which the enterprise provides the management and other personnel and assumes certain operating risks.

3. Concession contracts are divided into three common basic types, as follows:

(a) service contracts (also called contracting out transactions and concessions of public services);

(b) build/operate/transfer transactions (also called concessions of public works); and,

(c) concessions to use and/or operate public assets.

Usually, the concession of the right to carry out a public service, a public work project or to make use of public assets is made through a tender offering by the grantor in which each applicant presents a proposal comprised of the terms of the contract, the estimated capital and operating costs, the compensation price and the means of payment, among other details. In this manner the successful applicant will then undertake the activity in accordance with the terms and conditions which the grantor proposes.

4. The following paragraphs describe the characteristics of each of the above three types of concession contracts and the accounting treatment for transactions under the various arrangements. Other types of transactions between governments and enterprises which are not exactly government concessions but which should be treated as such are also considered in this report.

I. GENERAL CONCEPTS

5. Revenues and costs incurred in connection with concession agreements should normally be accounted for on an accrual basis. Before a concession contract is issued by a government body, any costs incurred by the prospective grantee, particularly in connection with obtaining the concession, should usually be recorded as expenses of the period in which they have been incurred. However, such costs may be deferred if the prospective grantee has reasonable evidence that the concession will be granted and the costs are clearly and specifically associated with the potential project.

6. When the grantee has to pay for the right to be granted a concession, this payment would usually be in the form of a front-end fee. The payment, or the incurrance of a liability to make a future payment, should be capitalized by the grantee as an intangible asset and amortized on a straight line basis over the

life of the concession or on a proportional method in relation to operating income if that would achieve a better matching of costs and revenues. If the transaction calls for the transfer of shares of the operating enterprise, or of another enterprise, as consideration for the value of the concession, the grantee should record the value of the concession obtained as an intangible asset subject to amortization with a corresponding credit in the appropriate stockholders' equity accounts for the fair value of the rights received or of the shares of stock, whichever is the most accurately estimable.

II. SERVICE CONTRACTS

7. These types of arrangements are usually specified within a contract in which the government grants an enterprise the right to carry out a specific public service using its own management and incurring the operating risks for a fixed time period. The enterprise is entitled to charge consumers for the services rendered at rates which include a profit margin. Service contracts may also provide for a specified sum of money to be paid by the grantee to the grantor. The grantee sometimes uses assets owned by the grantor which are returnable at the end of the contract together with any additional assets which the grantee owns. Examples of such assets are buildings which are constructed on public land and used by to the grantee during the period of the contract. Among the most common examples of public services operated by private sector and quasi-governmental enterprises through government concessions are gas, water, electric energy, telephone, public transport, garbage collection and public sanitation services.

A. Accounting treatment for rights to operate public services

8. The right to operate a public service may be granted either free or at a cost to the grantee. If the right is granted for a specified amount that is paid in advance, or for which there is an obligation to pay a defined fee at a later date, the cost of the right should be recorded as an intangible asset of the enterprise. This asset should then be amortized over the term of the contract on a straight line basis or on some other rational method that matches the expense for the accounting period with the benefits derived from the agreement.

9. Another type of transaction could be for an amount equal to the accumulated amortization of the intangible asset (the cost of the rights) to be paid to the grantor at the conclusion of the concession instead of in advance. However, the timing of the payment should have no effect on when the expense is recorded in the accounts. If the cost is paid monthly, the payment should be charged to an expense account in the records of the enterprise unless there is a mis-matching of the amount of the payment with the benefits received.

10. It is also conceivable that the consideration given to the government could be an equity interest in the grantee. This often occurs when a corporation is formed specifically for the purpose of being the recipient of a concession contract. In this situation the enterprise should record the fair value of the rights obtained as additions to its stockholders' equity accounts.

11. In other situations the concession rights might be granted at no cost. Regardless of whether or not there is a cost involved, the grantee should disclose the existence of the rights and the benefits to be derived therefrom in the notes to its financial statements, including details on the obligations which arise under the agreement.

B. Accounting for assets used in the operations of a concession

12. From an accounting point of view, one of the most controversial aspects of concessions occurs when assets owned by the grantor are transferred to the grantee for operating purposes. If the concession agreement calls for the grantee to pay the grantor for the assets, the following could occur:

(a) the grantee could immediately pay cash for the assets or agree to make payments at a later date. In this case, the grantee should record the fixed assets and liabilities, if any, on the records of the operating enterprise.

(b) the grantee could exchange shares of stock of the operating enterprise, or of another enterprise, as consideration for the value of the operating assets transferred by the government. In this case the grantee should record the fixed assets and corresponding credits in the appropriate stockholders' equity accounts for the fair value of the assets received or of the shares of stock exchanged, whichever is the most accurately estimable.

13. Another type of transaction might involve the government transferring certain operating assets to the grantee for use in operations with the ownership title to those assets being retained by the grantor. The assets essentially become the grantee's operating assets. The assets should continue to be recorded in the accounts of the owner (that is, the government) and no assets would be recorded by the grantee. However, if the grantee believes that the best disclosure from an economic disclosure viewpoint would be to record the cost of the use of the assets through periodic depreciation charges, an acceptable alternative would be for the grantee to also record the value of the assets on its books. Depreciation should be calculated in the same manner as for the grantee's other fixed assets or as a function of the term of the contract, whichever is shorter. Further, a deferred revenue amount should also be recorded that is equal to the value of the assets and this deferred credit would be amortized using the same method as used to depreciate the assets. This methodology is justifiable on the following grounds:

(a) Such assets generate income for the grantee and not for the grantor and therefore the assets should be reflected on the books of the grantee. The government may receive income under the terms of the concession agreement in relationship to the depreciation expense. Therefore keeping the assets in the accounts of the grantor does not reflect the economic substance of the concession agreement;

(b) the grantee has control as well as usage of the concession assets similar to a financial lease transaction and therefore this control should be reflected in its records; and,

(c) concession agreements are usually for a long duration and the assets might have no value to the grantor at the end of the concession period.

14. The grantee should disclose in the explanatory notes to the financial statements, in addition to the general disclosure items referred to previously, information on the assets utilized, their book value, and their life expectancy. There also may be a provision for such assets to be returned to the grantor if the grantee becomes insolvent or under certain other contingent circumstances as specified within the concession contract. If this is the case, the information should also be disclosed.

15. A third type of transaction might be for assets to be transferred to the grantee free of charge. In this situation the fair value of the assets should be considered as a donation to the grantee and recorded as such. The general treatment for government donations is for the grantee to record the assets received at their fair value and also record a deferred income account which would be subsequently amortized as the asset is depreciated. However, in certain countries it is allowable to record donations in a special account in the shareholders' equity section entitled, "Donated Surplus" or some similar title. A description of the accounting followed should be included in the footnotes to the financial statements.

C. Maintenance of returnable assets

16. In order to be able to return assets used in the operation of a concession to a condition that is acceptable to the grantor in accordance with the concession agreement, or in order to be able to achieve optimal utility from concession assets, the grantee may need to currently or prospectively renovate and/or repair the assets. Such renovations may require large expenditures for materials, parts, labour and other costs which would affect the financial results of the operating enterprise, especially if the assets are not operational for an extended time period which would prevent them from being used to generate revenues. The grantee should make current period provisions for significant costs for the renovation and/or repairs prior to undertaking such actions. The provisions would then be reduced by the amount of costs incurred when the renovation and repairs are effected. The purpose of this method is to match properly the revenues and expenses in an accounting period by distributing the costs of renovation and repairs over the entire period during which the assets are used. This will result in a more accurate measurement of the net income of each accounting period.

D. Accounting for concession assets at the termination of the concession agreement

17. If the grantee has title to enterprise operating assets but they cannot be retained for its use in other activities, either because they must be returned to the grantor or because the assets have special uses or have no other commercial value to the grantee, the net book value of the assets should be written off of the grantee's accounting records. Property improvements to public land provided under a concession agreement fall into this category. If the grantee has estimated his or her operating costs reasonably accurately, the net book value of the assets would be zero at this point in time because the book value should be equal to the residual value which, in this case is zero, and the asset should have been fully depreciated over the duration of the contract. Therefore, only in the event of the miscalculation of the depreciation and amortization or an early cancellation of the concession contract would a net book value other than zero be expected.

18. In the event that the grantee is to be paid for the assets returned to the grantor or transferred to another enterprise having a new concession for the operations, the amount could be a specified value, the fair value (which is more frequently the case), or the net book value of the assets. Any difference between the amount to be paid and the net book value of the assets to be transferred should be recorded as a gain or loss in the appropriate accounting period. Losses should be recorded in the accounting period when they are reasonably estimateable. However, gains should not be recorded until the accounting period when their realization is certain.

E. Fees due by the grantee to the grantor as payment for supervision and other services

19. If the grantee is contractually obligated to make payments to the grantor for its services, such as for supervision, monitoring and control of the quality of the public services, such fees should be recorded as normal operating expenses of the concession enterprise when incurred.

III. BUILD/OPERATE/TRANSFER TRANSACTIONS

20. Build/operate/transfer transactions (commonly called "BOT" transactions) give the grantee the right to construct or buy and operate a certain public work. BOT transactions typically occur under a long term contract to construct infrastructure projects such as roads, rail roads, bridges, viaducts, dams, airports, tunnels, etc., which take several years to complete. These transactions are usually entered into as a means for the government to finance the construction of a public work. The grantee receives from the grantor the right to carry out

the specific project and be suitably remunerated. In this case, the remuneration received normally comprises the payment for the construction costs incurred and a profit margin. Sometimes the grantee is entitled to operate the public works project after its completion in order to generate income. The operating income enables the grantee to recover the construction costs and the operating and maintenance expenses and to earn a profit margin. The grantee normally would also be allowed to recover any amounts that was paid to the government for the concession rights. At the end of the term of the concession the project assets and operating rights are transferred to the grantor.

A. Costs

21. Costs incurred for the construction of public works might include:

(a) materials used in the construction of the project, depreciation of fixed assets used in the work, etc.;

(b) labour costs related directly to the specific contract, i.e. costs of labour on the construction site, including supervision;

(c) indirect costs such as insurance, technical assistance, and indirect construction expenses; and,

(d) general or overhead costs such as administrative expenses or financial costs.

B. Accounting for income earned from a concession

22. The operating revenues earned under a BOT contract should be recognized when it is possible to generate income through the provision of services, usually to third parties, and when the related costs and expenses have been incurred or can be estimated. Otherwise, payments received from governments and others should be deferred as liabilities (deferred or unearned income) and revenues should not be accrued into the profit and loss accounts for the accounting period.

23. When the grantee has the right to receive income from the operation of a public work after its construction the construction costs incurred should be charged to fixed assets accounts. For example, road construction where the income is generated from the right to collect tolls. In one of the largest BOT transactions in history, the grantees who are responsible for the construction of the tunnel which links the United Kingdom and France have until the year 2041 to recover their investment through operations before they have to turn the operations back to the grantors of the operating rights.

24. Income for the construction of a public work should be recognized using the "percentage of completion" method of accounting for construction projects if the amounts earned can be reasonably accurately estimated during the period of construction. As an alternative, if the amounts earned cannot be estimated reasonably accurately the grantee may use the "completed contract" method of accounting, which would mean that construction earnings would be recognized upon the conclusion of the construction phase of the contract when the work has been completed to the satisfaction of the government. These two methods of accounting are accrual methods, which mean that the recording of income would be made when earned according to the principles described in this paragraph regardless of when amounts become billable to the government for cash flow purposes -- either on an interim basis or on completion of the project.

25. To achieve a proper matching of costs incurred and revenues earned, all pre-construction and construction costs should be capitalized when incurred (meaning paid or an obligation incurred to make payments at a later date) into asset accounts in the records of the grantee. Such amounts would then be transferred to accounting period profit and loss accounts when the related income is earned

on the accrual basis. If this method of accounting is not followed, the profit and loss accounts in the years of concession operations might show only the expenses incurred, and thus losses; and the year in which revenues are received in cash would show the earnings, which might not have been earned exclusively in that year. Of course, if all of the construction is completed and the revenues are earned in the same accounting period, there would be no violation of the generally accepted concept of the matching principle of accounting.

26. In applying the "percentage of completion" method of construction accounting, there are two ways which may be used to estimate the revenues earned during accounting periods:

(a) costs incurred during the year as a percentage of the total estimated costs of the project; and,

(b) revenue recognized on the basis of a technical report on the extent of the project's completion.

The percentage of the proportion of completion in method (b) should be applied to the amount of the total revenue set forth in the concession agreement. Also, related pre-construction and construction period costs should be charged to the same accounting period's profit and loss accounts, whether or not such costs have been actually paid in cash. However, for large and complex public works, particularly those with sub-projects of variable durations, it may be difficult to use one single percentage of completion with respect to the entire project. In this situation the ratio of costs incurred over the year to the total costs of the works is the best method to be applied to the total agreed revenues for the construction phase.

27. The use of either of these two methods permits the income to be distributed among the periods in which the work is performed, or the costs are incurred, and results in a more accurate economic measurement over time of net income for each year or interim accounting period than recognizing all of the revenues and costs and expenses at the completion of the contract.

C. Accounting for advance payments

28. Cash advances received for services to be performed in the future should be recorded as liabilities since the payments represent an obligation by an enterprise to perform services at a later date. If for some reason this is not possible, the advances would have to be returned under normal circumstances. Advances received which exceed the income earned in the period should remain under the "liabilities" section of the accounts until the services are rendered or the advance payments have been returned.

D. Provision for losses

29. When a loss is incurred under a contract, whether from construction or from operation of the project, it should be immediately recognized by the grantee as an expense in the current accounting period.

E. Transfer of the public works assets to the grantor following the termination of the concession agreement

30. When the agreement states that the grantee should not be fully or partially reimbursed for the assets transferred to the government at the end of the contract period the grantee's compensation is the revenues from the operation of the concession. In this case the assets should be depreciated down to their net realizable value, if any, at the conclusion of the contract. Generally, the net book value upon disposal will be equal to the amount of the repayment since the rate of depreciation must take into account the residual value of the concession assets. Any difference from what was recorded would be recognized as a gain or loss from the revision of an estimate in the accounting period when determinable.

If the contract states that the asset should be transferred at fair value any difference between that amount and the net book value is recorded in the profit and loss account.

F. Disclosures

31. In addition to the appropriate disclosures referred to in previous paragraphs of this report, the notes to the financial statements of concessions for the construction of public works should include the total value of the assets, the stage of completion at the balance sheet date, and the method adopted to recognize revenues.

IV. CONCESSIONS FOR THE USE OR OPERATION OF PUBLIC ASSETS

32. A concession to use and/or operate public property assets (usually fixed assets) is normally for a specified purpose and period of time. The grantee may compensate the grantor for the use of the assets. The grantee normally has temporary possession over the property and should be liable for all the costs and expenses and risks of using the assets or operating the activity to which the concession relates. Concessions to use buildings near public roads such as service stations, restaurants, snack-bars etc., are examples of this type of arrangement.

33. Because ownership of the assets remains with the grantor the assets should continue to be recorded on the books of the grantor as fixed assets together with the corresponding depreciation charges. A concession for the use of the assets is similar to an operating lease contract which specifies that recording fixed assets in the accounts of the grantor is an appropriate accounting treatment. However, it may be that the term of the concession is equal to or in excess of the economic and/or physical lives of the assets in which case the grantee might record the assets and related depreciation expenses as if the transaction was being accounted for as a financing lease.

34. If the grantee makes improvements to the concession assets which are not subject to reimbursement from the grantor and which result in a longer life expectancy for the assets, the expenditures should be recorded as "improvements to third parties' property" and be reported with other fixed asset accounts. Such amounts should be amortized over the remaining term of the concession contract or the life of the assets, whichever is shorter.

35. If the concession agreement requires periodic payments for the use of the assets, such payments should be recorded appropriately and proportionately as operating expenses in the period in a manner which matches the costs with the benefits (revenues) obtained from the operation of the concession. If the payment is made in full at the beginning of the contract it should be reported as a fixed asset or prepaid expense and amortized over the period of the concession. If the grantee has recorded the assets as if under a financing lease, the offsetting liability would be periodically reduced by the payments made to the grantor of the concession. If the use of the assets is free of charge the grantee would only disclose the benefit in the notes to the financial statement of the enterprise.

36. Usually grantees are contractually liable for returning to the government the public property that they have been using in good condition taking into consideration normal wear and tear. Hence the grantee must routinely repair and maintain buildings and other long-lived assets. The grantee should make provisions during current operating periods for any large scale expenditures for repairs and maintenance that are expected to be required at some future date.

37. Similar to the disclosures referred to in the previous section of this report the terms of the agreement, the characteristics of the property or other

assets, the duration of the contract, the remaining term, obligations of the grantee and any restrictions on the use of the assets should be disclosed.

V. MANAGEMENT CONTRACTS

38. Under a management contract a grantor such as a government assigns the operation of a commercial activity to a grantee, usually referred to as the "manager" of the activity. The purpose of a management contract is to obtain a party to operate a public service on behalf of the government; the government is still considered to be providing the public service.

39. The grantor is usually responsible for all of the expenses required for the operation of an activity, including the acquisition of materials and other appropriate assets and any operating and non-operating costs. The function of the manager is to execute the project through scheduling, supervising, consulting, and controlling the works or technical services.

A. Revenues for services performed

40. Many concession contracts have a term that lasts a number of years and in some situations the compensation (fees) may be fixed at the outset, or may be earned in relation to the costs incurred (commonly called a "cost plus" contract). The fees may be stated in the agreement as a fixed amount or may be as a percentage of the costs incurred. If the income is received as a lump sum, it should be taken into the current period's profit and loss account as in the case of long term construction contracts, namely:

(a) using the percentage-of-completion accounting method;

(b) as a percentage of the costs incurred; or

(c) after all of the contractual obligations have been performed.

As explained in an earlier section of this report, the first and second methods are preferred.

41. If the remuneration is on a cost plus basis the accounting method is simplified since the revenues correlate directly to the costs incurred on an accrual basis.

B. Disclosures

42. The manager should disclose in explanatory footnotes to its financial statements the existence of the management contract and its terms and obligations, including the total value of the contracted revenue and the method used to account for it.

VI. OTHER PRIVILEGES AND BENEFITS BESTOWED BY GOVERNMENTS

43. This section considers various privileges and benefits which may be granted by governments to grantees. The accounting treatments and disclosures, where different from the items described above, are briefly described.

A. Licenses for engaging in certain forms of economic activities

44. A license is an authorization to carry out an economic activity. It is different from a concession because the latter contracts are related to assets and services to be used for public purposes. A license is a means by which a government can control the initiation and operation of an economic activity while providing for the security, health, safety and environmental protection of the citizenry. The licensee should disclose in the explanatory footnotes to the

financial statements the term of the license granted, the conditions to be complied with, and any possible difficulties that it may have or has had in meeting these conditions and the resultant consequences.

B. Licenses for manufacturing and distributing products in certain geographic areas

45. The granting of a license by itself does not create special accounting and reporting implications. Expenses are usually incurred on a periodic basis for such licenses and are typically relatively low and do not justify deferral as assets.

C. Agreements without tender offers

46. There are situations in which the government may purchase assets or hire services without tenders because: the value of the transaction is insignificant; it is an emergency purchase; there is a highly recognized level of specialization of a certain supplier; or there is a monopoly for the goods or services to be provided. For the enterprise selected the transaction represents a normal commercial transaction. If any discount or special pricing arrangements are provided, the benefit given to the government should be accounted for as a reduction of normal gross revenues in the profit and loss accounts of the period. If the transaction is significant to the enterprise, it should be appropriately disclosed in the notes to the financial statements.

D. Export and import privileges

47. An enterprise that receives import or export privileges should record transactions in accordance with the terms of the rights obtained in the profit and loss accounts of the period. These transactions may be a form of indirect government assistance, and it is difficult to quantify the benefit in monetary terms because the total sales may not vary in proportion to the import or export tariff. Should this form of assistance have any significant impact on the financial statements of the enterprise, the enterprise should disclose the existence of this assistance and its characteristics, in particular its duration.

E. Rights to extract natural resources

48. The receipt of the right to extract natural resources is sometimes preceded by feasibility studies. The studies usually estimate the volume of the resources that exist, the quantity to be extracted, the amount of the revenues expected from exploiting the resources, and the costs necessary to execute the project. All of the costs connected with investigating and obtaining the project should be charged to current profits and losses when incurred, or when there is a high probability of success the costs and expenses for the pre-extraction phase can be deferred for matching with the sales revenues obtained in later accounting periods. In the absence of this probability the enterprise should charge all such expenses to the profit and loss accounts of the period in which they were incurred.

49. If a project becomes operational the enterprise should report periodically the costs which have been capitalized in order to commence the removal process. The percentage of depletion of the costs incurred in connection with the project is normally based on the volume of the current accounting period's production to the estimated total reserves of the resources as of the beginning of the period. As an alternative accounting method this percentage may be expressed as a function of the time period during which the license holder has the right to exploit the resources. If the government receives in kind a portion of the production of the resources, any costs incurred by the enterprise related to the extraction or production of the government's share should be charged to the enterprise's profit and loss account for the period.

50. The enterprise should disclose in explanatory footnotes the size and stage of development of the project as well as the volume of the reserve of remaining resources in accordance with the latest survey, as reduced by subsequent quantities produced, removed or extracted from the properties.

F. Rights to acquire raw and other materials and services at preferential rates

51. This is another form of indirect government assistance. No special accounting treatment is required to record the benefits obtained unless costs are incurred. The enterprise should disclose in explanatory footnotes the existence and nature of the benefits, the duration of the agreement and the significance of the benefits on the financial results of the accounting period.

G. Leasing transactions including land, buildings and equipment

52. Leases between the government and a private enterprise normally represent an operating right for a public asset. Therefore the lessee of the asset should record the rental expenses in the period's income statement. The enterprise should disclose in the notes to the financial statements the existence of the lease, the assets involved, their value and the resulting financial obligations and duration of the contract.

H. Rights to operate services such as a television networks and radio stations

53. The rights to operate public services such as television and radio stations are often cancellable by the government if the enterprise does not follow certain specific operating rules. The cost of the rights may be charged to the profit and loss account or be capitalized as assets, if significant, in the accounting period in which the costs are incurred. All of the other costs usually relate to the services rendered and therefore they constitute operational costs of the period concerned. All of the costs of the property and equipment necessary to operate enterprises of this nature are capitalized and depreciated in the same way as for other operations. If the government charges a periodic fee for the license, this amount should be charged to the profit and loss account for that period. The enterprise that holds the operating rights should disclose the kind of service for which it was granted the license and its duration.

I. Tax benefits

54. Tax benefits represent a form of government assistance and are an economic advantage to an enterprise which has met certain criteria. Such benefits may represent temporary or permanent benefits. Sometimes the purpose of the tax benefits granted is to stimulate the national, regional or local economy through investments or to encourage more expenditures for research and development activities. Tax benefits are normally only available after compliance with certain conditions and requirements which have been pre-established by the government. The most common tax benefits are as follows:

(a) tax exemptions which thereby eliminate certain tax obligations;

(b) tax rate reductions which represent the proportional decrease in the amounts calculated to be due;

(c) tax credits which represents a reduction from a known tax liability;

(d) tax devolution which represents a refund, totally or in part, of taxes already paid by the recipient provided that the enterprise has met certain obligations, conditions and requirements; an example of such a benefit are so-called duty draw-backs for importing assets which will be subsequently included in other assets that will be exported;

(e) current deductions for certain capitalized costs, such as the accelerated depreciation of fixed assets over normal rates that reflect the economic usage or useful life of the assets; and,

(f) tax holidays, which are exemptions from taxes for a defined period of time.

55. The notes to the financial statements should disclose the existence of tax benefits obtained, the reasons why they were granted, the amount of the benefits and their expected duration.

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Commercial Bank Accounting and Disclosures

Report by the UNCTAD secretariat */

Summary

Numerous national, regional, and international governmental and non-governmental bodies have promulgated guidance on accounting and financial reporting standards for banks. The guidance covers a broad spectrum of concepts and methods and reflects different levels and extent of disclosure and reporting. The purpose of this report is to provide governments and other interested parties with a structure for bank accounting and financial reporting that draws on the various standards and recommendations from authoritative bodies in a way which reflects the growing complexity of banking functions and the need to provide users of financial reports with useful information.

*/ This report was prepared with the assistance of Itzhak Swary of Tel Aviv University, Israel and Mordechai Spiegel and Moshe Ben Lulu of the Bank of Israel.

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INTRODUCTION

A. Scope of the report

1. This report discusses issues of financial accounting and reporting by commercial banks. It develops guidance for standard-setters with responsibilities for commercial banks. It does not cover commercial and industrial companies or other financial institutions such as insurance companies and securities brokers. However, such companies will find certain recommendations in this report both relevant and useful. This is the first time the Intergovernmental Working Group of Experts considered accounting for commercial banks. However, during its 12th session it did consider accounting for financial instruments. While no firm conclusions were reached by the Group on appropriate methods to value financial instruments, there was less difficulty in identifying appropriate disclosure rules. These are included in this report where relevant, particularly during the discussion of supplementary information which should be disclosed.

B. The expanded role of banks in modern capital markets

2. Traditionally commercial banks had the unique role of mobilizing domestic and foreign savings and allocating them among investors. Legislative and regulatory developments in the last decade have radically changed the business environment for banks. Banking deregulation has been both a cause and effect of the globalization of financial markets. Financial markets in developed countries have experienced both unprecedented growth and profound structural changes resulting from asset securitization, internationalization and reduced segmentation. Deregulation and innovation have steadily eroded the barriers that have traditionally protected banks from competition. Deposit institutions have been under increasing pressure from competitors offering new products while at the same time they lost their monopoly over their normal functions brought about by increased competition from other financial and non-financial firms. Money markets have seen the development of new types of securities, such as note issuance facilities, Euro-commercial paper, certificates of deposit, floating rate notes, notes with various forms of option features, and other complex financial instruments.

3. In countries with expanding securities markets, the importance of commercial banks as a source of funds to non-financial borrowers has shrunk dramatically. Further, even in countries where securities markets are small, banks have still lost loan business because their customers now have increasing access to foreign and offshore capital markets, such as the Eurobond market.

4. Diminishing profits have driven banks either: to attempt to maintain their traditional lending activities with expansion into new, riskier areas, such as commercial real estate and highly leveraged transactions (often bringing in additional concentrations of credit risks); or to pursue riskier, but more profitable off-balance activities. Off-balance sheet financing has assumed increasing importance for banks due to the pressure of increasingly uniform and stringent capital adequacy requirements. Off-balance sheet items were listed in detail in para 42 in E/C.10/AC.3/1994/5. Among them interest rate and foreign currency swaps, standby letters of credit, loan commitments, sales and transfers, and guarantees have become major activities for many banks.

5. A new activity that has generated particular concern recently is the expanding role of banks as dealers in derivatives products. Commercial banks have become users of derivatives not just on behalf of their customers but also to increase the profitability of their operations. Disintermediation has also increased the pressure for legislation to permit banks to expand their services into non-banking activities such as insurance. Although banks are investing in non-banking activities through subsidiaries and other forms of businesses, strict separation between banking and commercial or industrial activities remains the norm, except in some countries such as France, Germany and Switzerland.

6. The cumulative result of the recent developments has been the extensive erosion of the uniqueness of commercial banking. Bank products are becoming increasingly indistinguishable from the products of other financial and non-

financial firms. Clearly, the future of banking systems will be the universal banking model prevailing in Europe rather than the highly segmented American and Japanese models. Moreover, banks everywhere are likely to experience a market decline in their role in direct intermediation or asset transformation. Thus, their traditional role of accepting deposits and extending short-term credit will continue to diminish. In its stead, they will increase their involvement in indirect intermediation specializing in and servicing capital markets thus becoming essentially pure information processors. Banks will probably continue to play a role in payment systems. Economies of scope involving information will also take on a great role. It can be expected that banks will expand their activities whenever they can take advantage of the joint production of information services, for example, in credit card systems, trust activities, insurance, etc.

7. However, most developing countries, lacking efficient capital markets, probably will continue to rely on financial intermediaries, especially banks, that will maintain their traditional role in economic and monetary systems and within a regulated environment.

C. Accounting and reporting considerations in the new environment of commercial banking

8. Users of financial statements need to be able to assess the performance of banks not only from the perspective of investors but also from the viewpoint of depositors. Financial institutions have a unique role in the economy as compared to other commercial and industrial enterprises. Whereas the latter have a primary duty to provide information regarding their profitability and solvency to owners, creditors and employees, the former are bound to an even higher fiduciary standard since depositors expect that banks will provide a riskless safekeeping for their personal and business wealth. The users of financial statements of commercial banks need to be able to assess solvency, liquidity, and profitability. To do this they need information about the bank's risk exposure and management.

9. The move towards freer market mechanisms in developed countries is intimately connected with the move to deregulation and less government interference in financial markets. The growing role of the free-market determination of price and quantity in financial markets together with the evolvement of securitization and asset liquidation has created a need for market-based valuations in accounting and/or reporting by commercial banks and similar financial institutions. Opponents of market-based valuations and accounting argue that it is difficult to make accurate fair-value estimates of assets and liabilities. They claim that historical cost accounting has the important advantage of being easy to apply. On the other hand, proponents of market-value accounting and reporting argue that it is the only way that users of financial statements can get an indication of the economic net worth of the bank as well as its exposures to market and credit risks related to certain positions held. The adoption of market-value would have the advantage of making a bank's financial condition more transparent.

10. At the present time it does not seem that the accounting profession is ready to change from the historical valuation rules for all financial instruments. However, accounting standards which require disclosures based on the fair values of financial instruments have been adopted in several countries as well as by the International Accounting Standards Committee.

11. Concerning the changed environment necessitating an increasing demand for information about risk exposures and their management in banks, the public disclosure of banks' risks exposures would increase market efficiency and support market discipline. Banks should provide meaningful depictions of the risks associated with their operating activities including, in particular: credit risks, concentration of credit risks, interest rate risks, market risks, liquidity risks, and other operating risks resulting from on-balance sheet and off-balance sheet transactions, and a description of their ability to manage these risks. More public information about the risks incurred by banks will better enable users of financial information to evaluate and monitor banks' operations and will act as a deterrent to the taking of excessive risks by their management and directors.

12. Other important issues concerning commercial banks are the impairment of financial assets and loans, restructurings, hedge accounting and derivative financial instruments, the incorporation of the time value of money into bank accounting, and the sale and transfer of assets, to name a few. Rapid changes in financial markets and instruments have outstripped the accounting techniques used to measure profitability and risks. In the case of banks, the problems are especially severe and complicate the task of financial reporting, impacting on the reliability of regulatory reports necessary for prudential supervision.

13. Further, lack of international standardization in these areas has distorted the comparability of the capital positions of international banks. But this issue has been taken up in various fora of regulators such as the Basle Committee. These initiatives reflect the way in which the development of global markets has increased the need for international coordination of regulatory policies and the convergence in their content.

I. CURRENT INTERNATIONAL GUIDANCE

14. Guidance in the area of accounting and disclosures by enterprises generally, and by commercial banks in particular, has been promulgated by a number of international, regional and national organizations. Persons concerned with accounting and reporting by commercial banks should consider the conceptual frameworks that have been promulgated by these organizations for general purpose reporting to all users of financial statements. In addition, these organizations have recommended accounting principles for matters that apply to enterprises in all economic sectors, for example accounting for retirement benefit costs, leases, and taxes on income, and these should also be taken into consideration. However, commercial banks have unique operations that require special rules for disclosures, such as on liquidity, solvency, risks, etc. which require additional attention.

15. A description of the international guidance that currently exists follows.

A. The Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR)

16. ISAR previously studied the main objectives of general-purpose financial statements and the broad concepts that underlie their preparation and presentation. The results of this study and the recommendations of the Working Group are contained in the publication, Objectives and Concepts Underlying Financial Statements (New York: United Nations, Sales No. E.89.II.A.18).

17. A clear statement of objectives and concepts is useful in formulating national standards on accounting and reporting. This report contains information on: the objectives of financial statements in providing useful information to all users; characteristics of useful information; the elemental structure and general concepts underlying financial statements; and comments about some specific components of financial statements. These general accounting principles apply to both financial and non-financial entities.

18. ISAR has also issued guidance on accounting and reporting for specific matters which is contained in the publication, Conclusions on Accounting and Reporting by Transnational Corporations (New York and Geneva: United Nations, Sales No. E.94.II.A.9). Some of the sections which apply to commercial banks are: objectives and principles of accounting and reporting; consolidated financial statements; foreign currency transactions and translation; accounting for inflation; disclosure of accounting policies; information items for general purpose reporting; and contents of the Board of Directors report.

B. The International Accounting Standards Committee (IASC)

19. The IASC has also promulgated a framework for the preparation and presentation of financial statements as well as international accounting standards (IASs) on a number of specific accounting and disclosure subjects. IAS 30,

Disclosures in the Financial Statements of Banks and Similar Financial Institutions, is particularly relevant to the topic of this report. Also, a standard issued in 1995, IAS 32, Financial Instruments: Disclosure and Presentation, also applies to commercial banks.

C. The European Union

20. The Council of the European Union has issued a directive which relates to accounting and reporting for commercial banks, Council Directive of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions (86/635/EEC). The directive contains regulations on: the layout of bank balance sheets and profit and loss accounts; special provisions with regards to certain items in those financial statements; valuation rules; contents of notes to the accounts; provisions relating to consolidated accounts; and auditing and publication of the accounts.

D. Basle Committee on Banking Supervision

21. The Basle Committee has been working for a number of years on guidelines for the capital requirements for banks and this has resulted inter alia in the International Convergence of Capital Measurement and Capital Standards (1988) and the Amendment to the Capital Accord to Incorporate Market Risks (1996). More recently, the Basle Committee has been working with the Technical Committee of the International Organization of Securities Commissions (IOSCO) to study banking exposure problems relating to financial derivative transactions. Two documents were jointly issued in 1995 by the Basle Committee and IOSCO:

(1) Framework for supervisory information about the derivatives activities of banks and securities firms and
(2) Public disclosure of the trading and derivatives activities of banks and securities firms.

22. The first report describes the credit risk, liquidity risk, market risk and earnings information that banks need to develop and disclose concerning their activities in derivatives transactions. The report also describes a common minimum information framework which large banks active in the derivatives markets should produce.

23. The second report, issued later in the year, contains a survey of disclosures in the 1993 and 1994 annual reports of selected banks on their trading and derivatives activities. After comparing the qualitative and quantitative disclosures made, the report makes recommendations for disclosures in future reports by banks and securities firms about their activities in this area.

24. Considering the importance attached in the financial press in recent years to the significant losses experienced by banks and commercial and industrial companies from transactions in financial derivatives instruments, this guidance as well as guidance from the IASC is particularly timely and useful to governments and others interested in bank accounting and disclosure standards.

II. METHODS OF REPORTING BY BANKS TO USERS OF FINANCIAL INFORMATION

A. The annual reports of commercial banks

25. Annual reports should include the following minimum financial information:

(a) a balance sheet which summarizes the financial condition of the bank at the reporting date;
(b) a profit and loss statement which summarizes the income, profits and losses of the bank resulting from its operations for the reporting period;
(c) a report on the shareholders' equity which describes the changes in its components, including the permanent capital, retained earnings and capital reserves accounts. In certain countries the practice is to separate the report on changes in shareholders' equity from the report on changes in retained

earnings;

(d) notes to the financial statements which constitute an integral part thereof;

(e) a statement by the Board of Directors; and,

(f) an auditor's opinion on the statements based upon his or her examination.

26. The financial reports are historical documents (usually drawn up on the basis of the accounting convention of historical costs) and they contain mostly financial data. In some countries adjustments for the effects of inflation might be included. The information reported sometimes reflects estimates and professional valuations, as well as asset and liability evaluations made by the management of the reporting entity.

27. To increase the reliability of the reports and to strengthen the confidence of the users in the information contained therein, it is essential that the annual financial statements be examined by an impartial auditor. Information that accompanies the financial reports but does not constitute an integral part thereof also may be examined by the auditors in order to affirm that it does not contain misleading items or items that substantially contradict the information contained in the financial statements[1]. The subject of auditing is discussed further in a later section of this report

B. The basic financial statements

1. Balance sheets

28. The balance sheet, also referred to as the statement of condition or the statement of financial position, is a report which shows the financial position of the institution at a specific time, including its financial or other economic resources, other assets, obligations, liabilities, and the residual claims of the shareholders -- the shareholders' equity. The balance sheet, together with the other financial statements, is designed to reflect the state of liquidity and solvency of the bank and the relative level of risk including transaction concentrations relating to the various assets and liabilities accounts. Thus the main division into sections of the balance sheet is by the nature of the assets and liabilities.

29. However, balance sheets like all financial statements have limitations as to their usefulness because they only report on the accounts of the bank as of a specific date. The more current conditions in an institution could change dramatically in a very short period of time because of the nature of their operations.

30. The balance sheet of a bank is usually drawn up in descending order of liquidity but the classification is not into current and non-current assets. The reason for this is that the special nature of banking activities and banking products renders such classifications meaningless. However, for purposes of measurement, it is necessary to distinguish between fixed (or tangible) and intangible assets and assets held for "investment", and financial assets held to maturity, on the one hand, and assets intended to be realized in the near future -- such as loans held for sale, securities held for short-term profit-making, and real-estate held for sale.

31. The normal reporting procedure is to present the previous year's data in comparable figures in the balance sheet and in the relevant notes.

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[1] The International Federation of Accountants' International Standards on Auditing, Section 720, requires an auditor to read the information that accompanies the financial statements in order to determine if any material inconsistencies are contained therein. In such a situation, the auditor should require that such information be amended. Many countries have similar standards.

2. Balance sheet account classifications

32. The following major account titles are recommended to be reported in commercial banks' balance sheets:

ASSETS
* Cash and balances with central banks
* Treasury bills and other bills eligible for refinancing with central banks
* Deposits with other banks
* Securities
* Loans and advances[2]
* Investment in affiliates and participating interests
* Other assets
* Accrued interest receivable
* Total assets

LIABILITIES AND SHAREHOLDERS' EQUITY
* **Liabilities**
* Deposits from banks
* Other deposits[1]
* Debt evidenced by certificates
* Other liabilities
* Accrued interest payable
* Provisions for liabilities and charges
* Subordinated liabilities
* Total liabilities
* Minority interests
* In-substance capital liabilities
* **Shareholders' equity**
  - Paid up share capital
  - Reserves
  - Retained earnings
  - Total shareholders' equity
* Total liabilities and shareholders' equity

33. In addition, the body of the balance sheets should include a comment that the notes to the financial statements constitute an integral part of them.

34. The above format is suitable, with appropriate modifications, for either consolidated or separate legal entity balance sheets.

3. Comments about certain balance sheet items

General

35. In some countries it is the customary practice to provide greater detail within the balance sheet sections. In other countries it is optional to present certain details either in the body of the balance sheets or in the notes. The approach recommended in this report is not to overburden the body of the balance sheet with excessive details but instead to give the required disclosures in the notes. This approach is the accepted practice, *inter alia*, in the United States and the United Kingdom, although there are certain differences in the types of items appearing in the body of the balance sheets in different countries which arise from differences in the structure of the banking, financial and capital markets of those countries. The format above presents a uniform and broad structure for banking systems that differ in their legal and regulatory environments, as well as in the level of financial services, the degree of development of the markets, and the economic-business environment. Naturally,

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[2] When balances with the Government are substantial they should be presented separately.

[1] refer to footnote 2.

the presentation is subject to the rules of substantiveness and it is possible in principle to combine several non-substantive sections and present them as a single section. Nevertheless, in presenting a format for broad usage it is felt that such combinations will be rare in a normal bank with a wide range of operating activities.

36. A bank may present additional items in its balance sheets using the above format, either as sub-divisions of the above items or by creating additional sections for items not covered. Such items may also be included in sections entitled above as "other assets" or "other liabilities", with additional disclosures in the footnotes.

In-substance capital liabilities

37. In-substance capital liabilities include amounts for financial instruments that are equity instruments issued by the bank (capital) according to their economic nature but which cannot legally be considered part of shareholders' equity. The distinction between equity instruments and liability instruments is described in the IASC' IAS 32 which states that:

> "The substance of a financial instrument, rather than its legal form, governs its classification on the issuer's balance sheet. While substance and legal form are commonly consistent, this is not always the case. For example, some financial instruments take the legal form of equity but are liabilities in substance and others may combine features associated with equity instruments and features associated with financial liabilities. The classification continues at each subsequent reporting date until the financial instrument is removed from the enterprise's balance sheet.[4]

38. As a consequence, instruments which, from the point of view of their legal form, are equity instruments though in economic substance are debt instruments should be included in an appropriate liabilities section. A footnote should be included that details the relevant amounts to clarify the accounting treatment of these types of instruments.

4. Profit and loss accounts (income statement)

39. The profit and loss report of a bank is unique in that it presents financing as the main operating activity and details the various components of the income and expenses (interest) separately from those arising from other operating activities. Furthermore, as in all enterprises, the results of the bank's current activities are separated from results obtained from investments (as part of its ongoing activities) and from non-current or non-regular activities.

40. The report should normally be drawn up on a consolidated basis and include comparative figures for the previous year. There are two generally accepted methods for drawing up the profit and loss account: the horizontal method and the vertical method. The latter form is generally prevalent in the United States, the United Kingdom and other countries. The European Council's directive permits the use of either method, without a preference for one or the other. It is common practice to note data on the designation of profits in the margins as to the "retained profit account" (United Kingdom) or the "retained earnings report" (United States). However, the most appropriate place for this information is in the report on changes in shareholders' equity (see below for further comments).

41. The initial classification of income and expenses in the profit and loss account should be by type and not by source. Additional information classifying the income and expenses by source, with direct reference to the assets and liabilities sections, should be given in the notes. Offsetting (netting) of income and expense items is not appropriate unless it relates to hedges and to assets and liabilities which have been offset in the balance sheet. Profits and losses from trading activities such as securities and foreign exchange, and

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[4] IASC, IAS 32 "Financial Instruments: Disclosure and Presentation" , para. 19.

profits and losses from realizing investment securities, can be presented on a net basis. This is discussed further in a later section of this report.

42. Overall, the main body of the report should not be overburdened with information and additional details and clarifications should appear as footnotes.

5. Profit and loss accounts classifications

43. The following major account titles are recommended to be reported by commercial banks in profit and loss statements:

Net interest income
* Interest receivable and similar income
* Dividend income from investments
* Interest payable and similar charges
* Provisions for credit losses
* Net interest revenue after provision for credit losses

Non-interest income
* Fees and commissions receivable
* Net trading account (dealing) profits (losses)
* Net realized gains on sales of investment securities
* Net realized gains from sale of loans
* Other operating income
* Income from investments in associated companies
* Gains from disposal of investments in group companies

Non-interest expenses
* Salaries and employee benefits
* Depreciation and amortization
* Other occupancy expenses
* Fees and commissions payable
* Deposit insurance premiums
* Other operating charges
* Amounts written off on investments
* Losses on termination and disposal of group operations
* Group profits on ordinary activities (before taxes)
* Taxes on group profits
* Profits on ordinary activities after taxes
* Minority interests
* Group profit before extraordinary items

Extraordinary items and accumulated effect of change in accounting methods
Net profit (loss)
Profit per share
- primary
- fully diluted

6. Statement on changes in shareholders' equity

44. In order to report changes in the equity of the bank, the capital accounts should be classified and presented in the following groups:

* paid up share capital
* receipts on account of shares and receipts from options
* premiums on shares purchases
* revaluation funds
* funds reserved for redeeming shares
* currency translation differentials
* other funds (such as options and rights that have expired)
* total share paid up capital and capital funds
* surpluses (deficits)
* total shareholders' equity
* in-substance capital liabilities
* total shareholders' equity and in-substance capital liabilities.

45. The report on changes in shareholders' equity will present the amounts at the beginning of the year, the amounts at the end of the year, and transactions that occurred during the year separately for each component of the shareholders' equity accounts listed above. Amounts as of the beginning of the year and the end of the year for items which by law belong to the capital group but which by virtue of their economic nature were classified in the liabilities section will be noted as such. In the event of limitations on the distribution of surpluses and funds distributable as cash, notes will be made concerning the sums, the nature of the limitations, the period of the limitations and their conditions.

7. Notes to the financial statements

46. It is not practicable to describe in detail all of the items that should be included in the notes to the financial statements. Specifications on some matters are contained in the following sections of this report entitled "Supplementary financial data" and "Supplementary information". Following is a brief listing of the main topics that should be considered for disclosure in the footnotes:

(a) Summary of significant accounting policies, including the basis of consolidation, i.e. a description of how the assets, liabilities, profits and losses of subsidiaries have been treated in the group accounts; accounting policies relating to investments and bad and doubtful debts; adjustments for inflation; foreign currency translation adjustments; taxes on income, etc.;
(b) Cash and balances with central banks, including restrictions on cash;
(c) Treasury bills and other bills eligible for refinancing with central banks;
(d) Deposits in other banks;
(e) Securities;
(f) Loans and advances;
(g) Allowance for bad and doubtful debts:
(h) Investments in affiliated enterprises;
(i) Premises and equipment;
(j) Other assets;
(k) Foreclosed assets;
(l) Securities purchased under resale agreements;
(m) Sales and repurchase transactions;
(n) Loans sold with recourse;
(o) Leases;
(p) Deferred assets;
(q) Liens and other restrictive conditions;
(r) Deposits from banks;
(s) Other deposits;
(t) Debts evidenced by certificates;
(u) Other liabilities;
(v) Provision for liabilities and charges;
(w) Subordinated liabilities;
(x) In-substance capital liabilities;
(y) Shareholders' equity;
(z) Reserves;
(aa) Dividends paid, payable and proposed;
(ab) Earning per share, including the basis of the calculation;
(ac) Statutory and regulatory requirements, including capital requirements;
(ad) Detail of interest income and expenses by source;
(ae) Dividend income from investments;
(af) Non-interest income;
(ag) Salaries and employee benefits costs;
(ah) Pension schemes and details of their financing;
(ai) Post-retirement benefit plans;
(aj) Extraordinary profit and loss items;
(ak) Details of the current and deferred taxation provisions;
(al) Commitments and contingencies;
(am) Off-balance sheet credit risks;
(an) Off-balance sheet financial instruments, including derivatives;
(ao) Concentrations of credit risks;
(ap) Concentrations of other assets and liabilities;

(aq) Non-performing loans and other troubled debts;
(ar) Maturities of assets, liabilities and off-balance sheet items;
(as) Fair value and other information concerning financial instruments;
(at) Reporting by geographical and business segments;
(au) Related party disclosures, including related party transactions, interests in transactions and holdings, directors' emoluments, etc.;
(av) Trust activities;
(aw) Management and agency services;
(ax) List of principle subsidiaries, and other significant group holdings;
(ay) Government assistance; and
(az) Parent company separate reports (unconsolidated).

8. Consolidated financial statements

47. The financial statements of a banking enterprise should be presented in a consolidated format using an appropriate methodology. If a subsidiary of a banking corporation has been acquired with the intention of it being disposed of in the near future, for example a bank whose shares are being held temporarily as a result of a financial assistance operation with a view to its re-organization, the annual accounts of the subsidiary should be attached to the consolidated accounts and additional information given in the notes to the accounts concerning the nature and terms of the financial assistance operation.

9. The level of disclosure and exemption from disclosure

48. One of the problems in financial reporting for banks is deciding the appropriate level of disclosures that should be made. In this respect, banking confidentiality and maintaining the financial stability of the institution weigh heavily on decisions that are taken. Certain countries have introduced into their regulations guidelines which enable the banks to refrain from disclosing sensitive information that is likely to derogate from confidentiality or which reflect on the ability of the banks to obtain deposits. In Germany and Switzerland, for example, banks have the right not to disclose the provisions for doubtful debts and the market value of their investments. In the United States, on the other hand, the approach is one of full disclosure of the business situation of the institution including a description of its management of risks, information on interest rate differentials, allowances for doubtful debts, debts restructured and other problem debts, the market value of assets and liabilities, activity and exposures according to business and geographical sectors, credit concentrations, and many other matters.

49. Regardless of whether an item is explicitly required to be disclosed according to national regulations, all items of information should be detailed and any clarification should be given if:

(a) by their absence the financial reports do not give a true and fair view of the business condition of the banking enterprise at the balance sheet date, the results of its activities for the reporting period, and the changes in its shareholders' equity; and,
(b) the disclosures are required to ensure that the financial report or any part of it will not be misleading to readers.

50. A banking institution may add to the disclosure requirements but should not detract from them.

C. Supplementary financial data

51. The supplementary financial data are intended to support and complete the information contained in the financial statements by analysing and focusing attention on a number of key issues. When the bank issues consolidated financial statements the data should be presented on a consolidated basis. Specific items that are recommended for disclosure include:

(a) Development trends:
(i) a five year summary balance sheet and profit and loss account and comparative selected ratios for this period:

- per share data, including average common shares outstanding
- profitability ratios
- capital ratios
- other data, such as number of employees at the end of each period;

(ii) interim periods -- financial statements for the four quarters of the year with comparative figures for the previous year.

(b) Analysis of financing (interest) income and expenses to enable the user to compare the bank's performance in the financing area with comparable figures of its competitors. This data also enables the user to isolate and analyze factors affecting interest income and expenses;

(c) Information on interest rate risk. The disclosure described in the IASC's IAS 32 is as follows:

"Information about maturity dates, or repricing dates when they are earlier, indicates the length of time for which interest rates are fixed and information about effective interest rates indicates the levels at which they are fixed. Disclosure of this information provides financial statement users with a basis for evaluating the interest rate price risk to which an enterprise is exposed and thus the potential for gains or losses. For instruments that reprice to a market rate of interest before maturity, disclosure of the period until the next repricing is more important than disclosure of the period to maturity."[*]

The measurement of interest rate risk is still undecided and is the focus of the work of the Basle Committee and other regulators.

(d) Foreign exchange risk and liquidity -- the distribution of assets and liabilities according to their nominated currency and contractual maturities;

(e) Credit risks -- including concentrations, credits to foreign countries, credit risks of off-balance sheet items, information about troubled debts, and an analysis of the allowance for bad and doubtful debts, including movements in the allowance during the course of the year;

(f) Details of substantial concentrations of liabilities.

D. The report by the management and directors

52. Management and directors should explain the nature of their responsibility for preparing the reports in a statement that would normally be presented before the auditor's report. Issues such as the following should be addressed:

(a) The legal requirements for management and directors to prepare financial reports that truly and fairly reflect the state of the bank's business and the outcomes of its activities;

(b) The responsibility of management and directors to keep true and fair accounts, to preserve the organization's assets, and to prevent and disclose embezzlement, fraud, and other infractions;

(c) A declaration that proper accounting rules, implemented consistently and supported by conservative considerations and evaluations, were used in preparing the financial reports;

(d) A declaration that the reports were prepared according to generally accepted accounting principles and that any departure from such standards was disclosed and explained in the notes;

(e) A declaration that the reports were examined by independent auditors who received all of the necessary information and cooperation that they needed to make their examination and prepare their report;

(f) A declaration that management maintains a proper system of internal control throughout the year and exercises care that their actions taken were in accordance with all relevant laws, rules and regulations to which the bank is subject to preserve its safety and security;

(g) Management's evaluation of the effectiveness of the internal control structure and the internal control procedures; and,

(h) A statement that the organization is a going concern, with supporting

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[*] IASC, IAS 32, para. 58.

evidence or assumptions, as necessary.

53. Any area in which there is a deviation should be noted, giving details of the reasons for the deviation. The statement should be signed by the chairman of the board of directors, the general manager of the bank (the chief executive officer), and the senior officer that is directly responsible for the preparation of the accounts.

E. Supplementary information

54. Management should also provide a supplementary report with information concerning any events, trends or uncertainties which will have a substantial impact on the financial state of the bank or on the results of its operations. The information should be in the historical context but with a future perspective. Whereas the financial statements of the bank are based on historical data or other basis of accounting, the purpose of the supplementary financial information is to give a forward perspective and management's point of view. This part of the report should be the link between financial statements that give the results of past business activities and the external decision makers who are trying to ascertain the bank's future. Regulators within the United States follows such principles[*], for example.

55. Specific reference should be made to issues or developments which, at the reporting date, have a very high likelihood of occurring. Estimates should also be provided of the results that could occur if and when the developments materialize. The discussion of such matters is supposed to be read in conjunction with the basic financial statements and the supplemental financial data and is designed to amplify, augment and otherwise enhance the understanding of the substance of the information contained in the financial statements. The discussion should analyze what happened, why it happened, the implications for the bank's liquidity, capital adequacy, resources and operations, and how the event(s) may or may not be a consequence of events in the past periods, or is indicative of what may happen in future periods.

56. Information and developments in the bank's main areas of activities, its operations in business and geographic cross-sections, and developments during the course of the reporting periods should be disclosed. Five broad aspects of the bank's business should be addressed:

(i) the results of operations and the bank's profitability;
(ii) capital resources;
(iii) short-term and long-term liquidity;
(iv) capital adequacy, asset quality and risk management; and,
(v) information concerning directors and senior officers of the bank.

57. Information on substantial changes from one year to the next in the financial reporting sections, changes in accounting or valuations policies, and other effects of accounting measurement methods on the presentation of the business results and the financial situation can greatly enhance the reliability of the basic financial statements. However, the supplementary financial information should be interpretative and insightful and not merely reiterate the numerical data contained in the financial statements nor merely recite the changes from year to year which can be readily computed from the financial statements. The information a user expects to find in this report need not reveal specific business transactions, specific clients, or privy information of the bank.

58. The following details should be disclosed, to the extent that they are relevant and material, and may be reported upon using the data included in the financial statements, the supplementary financial data and any additional sources

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[*] United States Securities and Exchange Commission (SEC) Regulation S-K requires the disclosure of forward-looking information. FRR 36 (SEC Financial Regulation Release No. 36, 1989) differentiates between prospective information, for which disclosure is required, and forecasts for which disclosure is optional.

known to management:

(a) Information regarding management's handling of current issues, in order to characterise the bank's operations during the reporting period;

(b) Information obtained by management regarding trends or phenomena that are currently identifiable and that may significantly affect the bank's financial position and results of operations. This includes subjects or developments that are likely to occur and the expected specific influences that the matters should have on the bank. Reference should be made to events that occurred both before and after the balance sheet date and which will influence the bank as well as its subsidiary companies;

(c) Significant differences, from year to year, in the financial statements items if the explanations are conducive to understanding the bank's overall business operations. The explanations should include reference to those quantitative factors which explain the changes;

(d) Explanations of significant matters which the bank's external auditor sets forth in his or her report;

(e) Description of unusual developments during interim periods in the reporting year which caused operations to fluctuate disproportionately;

(f) Explanations for unusual accelerated remittances on assets or repayments of liabilities during the year, noting the estimated volume of the accelerated amounts and the principal changes in the terms and conditions of the items for which the remittances and repayments were accelerated;

(g) Unusual fluctuations in income and expenses accounts, including reference to tax expenses and irregular transactions and their effect on the group's net profits. Reference should be made to the bank's and the consolidated group's profitability using relevant ratios and measures that explain return on capital, income components, factors that influence net profits, efficiency of utilizing resources, and so forth;

(h) Average rates of income earned on financial assets, the average expense rates on liabilities and the interest gaps or margins, including a reference to the volume and price effects on interest income and expenses;

(i) The effect of provisions for doubtful and bad debts and the amount of doubtful and bad debts collected during the period;

(j) The structure of the group's assets and liabilities, including comments about core and non-core business activities;

(k) Details of significant changes in the portfolio of real estate held by the bank and its subsidiaries, and the difference between the book values and the market values of these assets at the end of the year;

(l) Particulars regarding investment activities, especially those investments carried at an amortized cost:

(i) If the market value of the portfolio is lower than its book value, an evaluation should be made of the implications of the imputed loss on the bank's net worth and capital requirements;

(ii) An analyses and quantification of the expected effects on current net profits, future net profits, return on investment, liquidity and financing as a result of:

- significant unrealized losses in the portfolio;
- significant sales of securities at a profit; and,
- significant changes in the average maturity of the investments.

A similar analysis should be performed in cases where a significant portion of fixed interest mortgage loans with maturity dates of more than one year bear lower interest rates than the current interest rate;

(iii) If significant unplanned sales were made from the investment portfolio, the report should describe those transactions which were not forecast in the past and which caused management to modify its investment strategy. The fact that this possibility was not predicted in disclosures of previous years may need to be highlighted;

(iv) If a significant portion of the portfolio includes securities that are not actively traded in a liquid market the report should disclose these securities and describe their nature and the source of information used to determine their market value. Each significant risk related to the investment *vis-a-vis* profitability and liquidity should be discussed. If the portfolio is comprised of financial instruments with an

especially volatile market value and if this volatility may significantly harm business results or liquidity, appropriate disclosures should be made.

(m) The status of the bank's capital resources and any changes therein, including capital issues and dividend distributions and information on declared dividend amounts in the current year and the prior year;

(n) A description of the risks to which the bank is exposed and a description of the bank's risk management principles and methods. Reference should also be made to the various risk ratios which the bank has developed and specific details of the means used by the bank to measure and manage risks. A separate reference should be made to:

(i) credit risks;
(ii) price risks;
(iii) interest rate risks;
(iv) currency and market risks;
(v) market liquidity risks and funding risks;
(vi) governmental/political risks (including country risks);
(vii) operational risks; and
(viii) any other relevant risks that may have a significant bearing on the bank's activities and the results of its operations.

In this framework references should be made, *inter alia*, to provisions for doubtful debts, the credit risks of on-balance sheet and off-balance sheet items, significant credit concentrations, collateral policies and the types of collateral *vis-a-vis* different types of credit. Also reference should be made to:

(i) collection activities and amounts which are in the process of collection;
(ii) specification of credit exposures by business segments and countries;
(iii) an analysis of the repayment periods and the duration of assets and liabilities;
(iv) the fair value of assets and liabilities; and
(v) other relevant information.

(o) An analysis by business segment of income and expenses incurred by the group and details on assets and liabilities in each segment, along with developments that have occurred in the operations of each segment;

(p) A description of the geographic layout of the bank's operating locations outside of its headquarters noting the branches in foreign countries. The major developments at the locations during the reporting period should be described. An analysis by geographic segments should be made of the income and expenses of the group, with specifications of assets and liabilities and related significant developments;

(q) Activities of the group's main associated companies, including significant developments in their assets, liabilities, income and expenses. The group's return on its investments in these companies should also be disclosed;

(r) The effects on the bank's business results from principal developments in the banking industry, both locally and abroad. Background data on local and worldwide economic and legislative developments should be provided if relevant. Reference should be made as necessary to matters of supervision and compliance with regulatory requirements;

(s) Details regarding transactions with related parties which were not conducted at "arms' length", and any significant transactions that were conducted after the balance date or for which there are intentions to enter into such transactions;

(t) Information on off-balance sheet activities such as trustee, proxy, agent, dealership or managerial operations. The bank's involvement with financial instruments and the group's non-banking activities should also be disclosed. If the bank or its subsidiaries took part in trust activities, these should be described along with the associated income related to these activities by type of trust;

(u) Discussion of the bank's liquidity, the management's policy for raising resources;

(v) Changes in the bank's organizational structure, including branches and

personnel, and a review of related policies and plans. Disclosure should be provided on the number of employees and on any employment agreements. This employment data should be presented by operating activity in the local and foreign markets;

(w) A diagram or list of the group's holdings in other corporations and a description of the respective capital interests and voting rights (or right to appoint directors);

(x) The names of all the directors of the bank who held office during the year. Additional information concerning the directors who were in office at the end of the year should be provided, for instance their principal occupations, other organizations in which the directors hold offices or in which they are member of the board of directors, and the unexpired period of the service contract of each director proposed for re-election. The independent external directors of the bank shall be identified and a short biography presented about each. The names of the members of the Compensation and Audit Committees should be presented.

(y) The names of the senior management should be detailed and the position and compensation (including salary and benefits) of each, either received directly or indirectly during the year from the bank and its subsidiaries;

(z) The number of meetings held by the board of directors during the reported year;

(aa) The emoluments and other benefits paid or provided directly or indirectly by the bank or its subsidiaries to the chairman of the board of directors, separately, and to all other directors as a whole;

(ab) Any sums loaned or guaranteed by the bank or its subsidiaries in favour of the bank's directors;

(ac) Details of the interests of directors and senior managers and their immediate families in significant agreements that were concluded during the year, or that are in force at the end of the year, in which the bank or one of its subsidiaries is a party. If no such agreements exist, a statement to this effect should also be included;

(ad) The financial interests of the directors and senior management in shares, debentures, options, and convertible securities of the group should be disclosed. The report should distinguish between beneficial and non-beneficial interests;

(ae) A declaration as to whether the bank has purchased insurance for directors, officers, employees, or auditors against liabilities related to the bank's activities;

(af) Details regarding the acquisition of the bank's own shares during the year, or possession of the bank's own shares in any other manner. The following details should be noted:

(i) Number and nominal sum of the shares;

(ii) Their portion of the paid-in capital;

(iii) Cost paid and the reason for the acquisition or circumstances for the transfer of ownership to the bank;

(iv) Shares that were cancelled or sold during the year;

(ag) Disclosure of donations to political persons, entities and other bodies by the bank and its subsidiaries if the amount is significant;

(ah) Description of the character and the extent of current or expected governmental financial aid and its effect on the bank's financial position and results of its operations;

(ai) Presentation of all other data that, in the opinion of the board of directors and management, could be of importance to the users of the report in order to clarify the state of affairs of the bank and its subsidiaries and to prevent misleading interpretations.

III. SPECIFIC ACCOUNTING AND REPORTING MATTERS

A. Measurement of interest income and expenses

59. The method for recognizing income and expenses from interest-bearing assets and liabilities, excluding non-performing assets, is the so-called "interest method". Other methods of recognizing income can be used only to the extent that they constitute a true and fair approximation of the interest method. This method calculates interest on the basis of the effective yield, using the outstanding balances of the respective assets or liabilities accounts. The amortization of

premiums and discounts should be calculated on an actuarial basis so as to produce a level yield over the period to maturity. A straight line method may be used only if it does not materially distort the reported profits. The amounts of remaining unamortized premiums or discounts must be disclosed in the notes to the accounts.

60. The most common practice followed is to disclose the balance of the cumulative interest receivable and payable in the balance sheet under separate headings within the assets and liabilities sections. Alternatively, the balances could be added to the assets or liabilities from which they are derived, but this is not the recommended practice. The amounts of interest paid or received during the operating period covered by the report and for comparative amounts from preceding periods should be presented separately within the "other assets" and "other liabilities" classifications.

B. Netting of amounts

1. Balance sheet netting

61. In many countries, for example in the European Union, netting is prohibited, even for debit and credit balances for the same customer. For example, in the United Kingdom it is prohibited to net assets and liabilities as well as to net income and expenses.[7] However, debit and credit balances should be netted if they truly are not separate assets and liabilities. This should also be followed for the economic reality of certain of the new financial instruments that have emerged in recent years. Nevertheless, there are differences in the netting conditions permitted in certain countries. Generally, the conditions for netting are as follows:

(a) the reporting entity and the other party owe each other a determinable monetary sum denominated in the same currency or another exchangeable currency;
(b) the reporting entity can impose a net settlement for completing the transaction; and,
(c) the capability of the entity or person as stated in part (b) to complete the transaction is assured beyond any reasonable doubt and there is no chance that the reporting entity will be required to pay its liability without realizing the related asset.

62. A British Banking Association Statement of Recommended Practice (SORP) on accounting for advances recommends the implementation of netting only when there is a legal and enforceable right of netting between accounts in the event of the liquidation of the other party and only when there are no circumstances beyond the control of the banking entity that are likely to impede its ability to realize the right to a recovery from the asset involved in the transaction. The EC banking directive (see Section *I.C.* above) does not deal with this issue. However, the IASC[8] IAS 32 adopts the benchmarks established in the United States Financial Accounting Standards Board (FASB) Interpretation No. 39 which is concerned with the netting of assets and liabilities. The criterion adopted by the IASC states that:

> "A financial asset and a financial liability should be offset and the net amount reported in the balance sheet when an enterprise: (a) has a legally enforceable right to set off the recognised amounts; and (b) intends either to settle on a net basis or to realise the asset and settle the liability simultaneously."

63. The standard requires the presentation of financial assets and financial liabilities on a net basis when this reflects an enterprise's expected future cash flows from settling two or more separate financial instruments. When an enterprise has the right to receive or pay a single net amount and intends to do

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[7] para. 5(1) of Schedule 9 of the Company Law.

[8] IAS 32, paras. 33-34.

so it has, in effect, only a single financial asset or liability. In other circumstances, financial assets or financial liabilities should be presented separately from each other, consistent with their characteristics as resources or obligations of the enterprise.

64. The IASC's IAS 32 permits netting between amounts from different customers when there is an agreement between the bank and the two parties to this effect[9]. Finally, the IAS also allows netting under conditions of a "master netting arrangement", in which more than two parties are involved[10].

2. Profit and loss account netting

65. The recommended policy for the netting of amounts in the profit and loss statement is the one that has been promulgated by the IASC in IAS 30. This standard states that:

(a) netting is permitted in the profit and loss accounts where it is permitted between the relevant assets and liabilities in the balance sheet because a legal right of offset exists and the offsetting represents the expectation as to the realization or settlement of the asset or liability; or where

(b) the income and expenses are netted as a result of the implementation of hedge accounting.[11]

C. Reserves

1. Reserves for general banking risks

66. The EC bank directive permits the creation of a reserve for general banking risks, as a liability item, and requires the creation of such a reserve in the case of application of the option of downward revaluation of assets on the grounds of conservatism (Art. 38). IAS 30 permits the creation of reserves for general banking risks, including future losses or other risks not yet identified; however, the reserve is not to appear in the profit and loss account but is to be registered directly as an adjustment of surpluses which will be presented separately.

67. It is recommended that care be taken that the creation of reserves for general banking risks does not become an instrument for manipulating and smoothing profits which would derogate from the ability of users of information to compare the financial condition and performance of banks.

2. Hidden reserves

68. Many governmental authorities and other persons assert that hidden reserves should be maintained in the interest of security for depositors. The position that hidden reserves enable a bank to achieve stability of its reported profits by transfers to and from these reserves. Hidden reserves can be created in two ways: one is by maintaining an internal reserve and the second is by a downward revaluation of assets.

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[9] IASC, IAS 32, para. 36.

[10] The manner in which the British Bankers' Association SORP relates to netting does not prevent netting to be followed in a situation in which more than two parties are involved, such as the case of a mutual guarantee which creates the right of netting between the accounts of related companies on condition that "the relationship is in substance a single banking relationship". Even though the guideline in the British SORP appears to be broader, the requirement of the IASC for an agreement between the parties is a practical one (see IAS 32, paras. 36 and 41).

[11] IASC IAS 30, para. 13.

69. The EC bank directive[12] gives member countries the option of a certain degree of downward revaluation of assets by up to 4% of their worth before revaluation. This option would appear to conflict with the requirement to present a true and fair view of the state of the business, but the EC directive justifies it as being conservative. The United Kingdom did not introduce this option when adapting its laws to the EC directive and therefore does not permit the creation of hidden reserves at all, not even through downward revaluation of assets.

70. It is recommended that reserves or provisions for losses on assets be created only in accordance with the economic substance of events that have occurred and not as a means of providing hidden reserves. Depreciation and amortization should be recorded only in accordance with accepted methods and rates.

D. Disclosures about derivative financial instruments

71. In 1994 the Intergovernmental Working Group of Experts on International Standards of Accounting and Reporting (ISAR) studied the subject of accounting for the relatively new types of financial instruments and their report is included in the publication, International Accounting and Reporting Issues: 1994 (New York and Geneva: United Nations, 1995), pp. 61-69). In 1995 the International Accounting Standards Committee published International Accounting Standard 32, Financial Instruments: Disclosure and Presentation. In addition, the European Council, the British Bankers' Association and the United States Financial Accounting Standards Board, among others, have published guidance in this area.

72. IAS 32 requires information to be furnished for all financial instruments regarding their extent and nature, including significant terms and conditions that could affect the amounts, their timing and the certainty of future cash flows. IAS 32 further states that banks should disclose the essential characteristics of the instruments, referring to proper grouping of similar instruments. When financial instruments expose the enterprise to significant risks, IAS 32 requires that the following information be disclosed:

(a) The instruments' principal, stated, face and notional amounts, maturities, options that are related, and cash flow characteristics and;
(b) Information about interest rate risks, including data about off balance sheet instruments.

73. IAS 32 further states that where there is a relationship between financial instruments that could affect the enterprise's normal cash flow, such as in hedging transactions, it is important to disclose the relationships that exists and the enterprise's exposures to risk.

E. Concentration of transactions

74. An important disclosure that should be made by commercial banks is information relating to concentrations of their transactions. Appropriate guidance is given in the IASC's IAS 30, paragraphs 41 and 42, which state the following:

> "A bank [should disclose] significant concentrations in the distribution of its assets and in the source of its liabilities because it is a useful indication of the potential risks inherent in the realisation of the assets and the funds available to the bank. Such disclosures are made in terms of geographical areas, customer or industry groups or other concentrations of risk which are appropriate in the circumstances of the bank. A similar analysis and explanation of off balance sheet items is also important. Geographical areas may include individual countries, groups of countries or regions within a country. Customer disclosures may deal with sectors such as

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[12] Council Directive of 8 December 1986 on the annual accounts and consolidated accounts of banks and other financial institutions (86/635/EEC), Article 23.

governments, public authorities, and commercial and business enterprises...

75. The disclosure of significant net foreign currency exposures is also a useful indication of the risk of losses arising from changes in exchange rates."

F. Trust estates and collateralized assets

76. A business transaction conducted by a banking institution in trust for a third party, an asset held by such organization as a trust estate or assets that others have collateralized in the bank's favour should not be presented in the financial statements unless such assets are cash in hand which mingles with the totality of the bank's activities. Such an asset can be netted against the corresponding liability part of the transaction for a depositor of the guarantee if the netting criteria have been met (see the section on netting above). An exception can be made in the case of collateralized assets which are, in substance, a foreclosure according to the accounting rules. In this case they will be presented in the "other assets" section of the balance sheet.

IV. BANK AUDITING

77. In almost all countries the accounts of banks are examined by an independent auditor. These examinations tend to be of two types: those where the auditor concentrates on whether the accounts are properly prepared in accordance with national laws and regulations, and those where there has been a more thorough review and examination of the business and individual transactions to ensure that the financial statements reflect a true and fair view of the banks' state of affairs and the results of its operations.

78. It should be emphasized that the objective of an audit examination of a bank, as for enterprises in any other economic sector, is not primarily to prevent business failures but to render an opinion on the fairness of the financial statements. In carrying out their role, independent auditors of a bank should be aware of the general business and economic risk factors that affect the industry as well as the specific operating features of banks that may cause special problems. In particular, the auditor must be aware that:

(a) Banks have custody of large volumes of money and other easily liquidated instruments whose physical security has to be assured. This applies both to the storage and the transfer of money and this makes banks vulnerable to misappropriations and frauds. Therefore, banks need to establish, implement and enforce rigorous systems of internal control and operating procedures;

(b) Banks engage in large volumes and varieties of transactions both in terms of number and value. This necessitates complex accounting and internal control systems and extensive dependence on computerized systems to process transactions;

(c) Auditors of banks should give particular attention to the assessment of the possibility that financial assets might be impaired as well as other risks involving financial instruments;

(d) Banks usually have wide geographical dispersion, including establishments in foreign countries. This necessarily involves a greater decentralization of authority and dispersal of accounting and control functions with consequent difficulties in maintaining uniformity of compliance with organizational policies and operating controls. Following are some of the factors that have to be considered:

(i) Banks frequently engage in significant off-balance sheet activities that may not involve accounting entries and which might not leave an audit trail.

(ii) Banks are regulated by governmental authorities and regulatory requirements which often influence accounting and auditing practices. Non-compliance with regulatory requirements could have significant implications on the banks' financial viability.

(iii) Banks are frequently very vulnerable to abuses through related party transactions because of the easy access to cash and because of the large flows of funds in a bank's operations. Particularly in international operations, banks are frequently exposed to a large

number of related parties. Identifying all related parties may be very difficult and may cost more than the benefits acknowledged by users of financial statements. The growing complexity of transactions makes it also difficult to trace the terms and conditions of transactions with related parties that were not executed in the ordinary course of business.

79. As a result of the industry's particular features, the auditors of banks face larger audit risks. Developments during the last decade have made their work even more difficult. In this respect deregulation, institutionalization and globalization has had three significant impacts on bank auditing risks:

(a) Inherent risks: auditors face a non-consistent business environment that includes intensive competition, product innovation, and a rising scale of exposures to risks;

(b) Control risks: internal supervision and protection mechanisms tend to reduce control risks in banks. Deregulation has loosened supervision in certain areas, consequently contributing to potential increases in control risks. The growth in the complexity of financial markets has accelerated the development of sophisticated real-time EDP systems which have greatly improved the potential for control, but which have in turn brought with them additional risks arising from the possibility of computer failure or fraud;

(c) Detection risks: the increasing complexity of banking activities and the continuing development of new products and banking practices challenge the auditor's knowledge and understanding of the banks' businesses and their associated risks. Expanding off-balance sheet activities and complex evolutionary financial instruments, which have not been matched by the concurrent development of internal controls, accounting principles and auditing practices, has left auditors exposed with a risk of inadequate professional support for their responsibilities.

80. The consistently changing regulatory environments force auditors to keep apprised of recent regulatory changes, and it may be argued that the auditing profession is unable to unilaterally work through existing regulatory and profession structures to make significant progress in meeting the developing needs of users of financial information.

81. In addition, in the last decade regulators have laid further responsibilities and duties on bank auditors. Increasingly auditors are obligated to report to the supervisory authorities on certain matters, or else there is a tripartite agreement (or trilateral meetings) among the bank management, supervisory authorities and auditors requiring direct disclosures of certain matters to the authorities in specified circumstances.

82. In conclusion, the audit risks and responsibilities of banks' auditors have been dramatically increased in recent years and go far beyond those of auditors in other industries.

V. CONCLUSIONS AND FINAL RECOMMENDATIONS

A. The future of commercial banking

83. Banks everywhere are likely to experience a marked decline in their role in direct intermediation or asset transformation. Thus their traditional role of accepting deposits and extending short-term credit will continue to diminish. In its stead, they will increase their involvement in indirect intermediation, specializing in and servicing capital markets. Economies of scale involving information will also take on a great role. It can be expected that banks will expand activities whenever they can take advantage of joint production of information services, for example in credit card systems, trust activities and insurance. However, most developing countries lack efficient capital markets and will probably continue to rely heavily on financial intermediaries, especially banks, to maintain their traditional primary role in economic and monetary systems. Banks will usually be subject to restrictive regulation but will not necessarily be closely supervised.

84. The move to freer market mechanisms in developed countries is intimately connected with the move to deregulation and less government involvement in financial markets. The growing role of free-market determination of price and quantity in financial markets together with the evolution of securitization and asset liquidation has laid the foundations for market-based valuation in banks and similar financial institutions. Opposition to market-value accounting centers on the difficulty of making accurate market value (fair-value) estimates of assets and liabilities. It is claimed that historical cost accounting has the important advantage of being easy to apply and is not subjective. In addition it is considered inappropriate to apply market-values to assets being held to maturity. Proponents of market-value accounting principles argue that it is the only way users of financial statements can get an indication of the economic net worth of the bank, as well as of its economic exposure to market risks and credit risks related to certain positions. The adoption of market-value accounting has the advantage of making a banks' financial condition more transparent.

85. Today it seems that the accounting profession is not ready to take the step of changing from the historical based valuation rules for all financial instruments. However, several countries and the IASC have recently taken the approach of requiring disclosures about the fair value of financial instruments.

86. Another important accounting subject evolving from the changed environment of banks is the increasing demand for information about risk exposures and risk management of banks. Public disclosure will increase market efficiency and support market discipline. Banks should provide a meaningful depiction of the risks associated with their activities, including in particular: credit risks, concentration of credit risks, interest rate risks, market risks, liquidity risks and other operating risks resulting from on-balance sheet or off-balance sheet transactions, and a depiction of their ability to manage these risks. More public information about the risks incurred by banks will better enable users to evaluate and monitor them and may act as a deterrent to excessive risk taking.

87. However, in the case of BCCI, more disclosure would not have helped depositors but more transparency would have helped the regulators who are supposed to protect depositors. One problem in the BCCI case was cross commitments between individuals and institutions. BCCI was really an issue of inadequate and non-transparent internal controls. Questions were also raised about what was and should be the role and responsibilities of the board of directors and the auditors of a multi-national banking institution.

88. Further, there are no international laws or rules on liquidation of banks and in the case of BCCI different groups affected by the collapse received compensation for varying proportions of the losses they sustained.

89. And there are other important accounting issues concerning banks that need to be addressed by standards setters, such as impairment of financial assets, loan restructurings, hedge accounting and derivative financial instruments, incorporating the time value of money into the accounts, and sale and transfer of assets. Rapid changes in financial markets and the development of new financial instruments have outstripped the accounting techniques used to measure profitability and risks. In the case of banks, these problems can adversely affect the reliability of regulatory reports necessary for prudential supervision.

90. Further, the lack of international standardization in these areas has distorted the comparability of the capital positions of international banks. But this issue has been taken up by various fora of regulators such as the Basle Committee. Theses initiatives reflect the way in which the development of global markets has increased the need for international coordination of regulatory policies and convergence in their content.

B. Towards improved bank disclosures

91. The IASC in its project on comparability and the European Council through its directives have managed to pave the way to creating a framework that will work towards eliminating the lack of harmonization that is currently permitted in the rules and requirements imposed in different countries. However, the IASC does

not provide a full set of disclosure rules and the EC directives apply only to member countries and are therefore adapted exclusively to the European economic environment.

92. This report has presented recommendations for broader disclosures for banking enterprises operating in either a domestic or international environment. The report endeavours to broaden the scope of traditional bank disclosures, particularly for standards-setters in developing countries and countries in transition. The establishment of a universal disclosure system requires, on the one hand, a proposal for a broad structure that will be able to accommodate the differences arising from variations in the banking systems and money and capital markets throughout the world. On the other hand, due consideration must be given to the preservation of the benefits inherent in the information required under the specific disclosure rules of any particular country.

93. This consideration has led to the dispersal of the recommended information among the primary financial statements, the notes, and other parts of the annual report. One of the outcomes is therefore that in certain countries the details of the main reports may be broader than the proposed format of this report, but in other countries there is a possibility that a substantial part of the secondary details in the notes are superfluous. A possible solution to this problem in accordance with the guidance in this report is to permit flexibility in the choice of level of detail or grouping, subject to the principle of substantiality which will be determined by an enterprise's management. The degrees of freedom in this choice, as in the matter of possible derogation from the proposed disclosure rules, should be a function of the overriding principle obligating proper revelation of the financial condition and business results of operations.

94. The importance attached to this last problem derives from the belief that unsuitable information, that is insufficient or excessive information, is detrimental to the effectiveness of the information contained in the reports and may even render it ineffective altogether. In other words, in parallel with the concern for full disclosure, care must be exercised to ensure that the reports are not unnecessarily cumbersome. True and fair disclosure in each of the parts of the annual report will provide users with the necessary information to evaluate the bank and the results of its activities and facilitate informed decisions being made.

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